CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

June 22, 2006

H.R. 5527
Mark-to-Market Extension Act of 2006

As ordered reported by the House Committee on Financial Services on June 14, 2006

SUMMARY

H.R. 5527 would extend the Multifamily Assisted Housing Restructuring and Affordability Act of 1997 (MAHRA) for five years beyond its current expiration date of September 30, 2006. That law authorizes the so-called mark-to-market approach for renewing Section 8 Housing Assistance Payment (HAP) contracts and for the restructuring of certain mortgages insured by the Federal Housing Administration (FHA). Under the mark-to-market approach, HAP contracts are renewed at market rents for FHA-insured projects that currently receive above-market rents and, if necessary, the mortgages for those projects are written down to levels that could be supported by the lower rents. In addition, the bill would extend debt restructuring eligibility to properties damaged by disasters and expand the program's authority to set rents above 120 percent of the fair market rent.

CBO estimates that enacting H.R. 5527 would prevent some projects from defaulting on FHA-insured mortgages and thus reduce direct spending by $188 million over the 2006-2011 period. We also estimate that implementing H.R. 5527 would allow for savings of $25 million in discretionary spending over the 2007-2011 period, assuming that future appropriations are reduced to reflect the lower costs of Section 8 contracts.

H.R. 5527 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA); any costs to state, local, or tribal governments would be incurred voluntarily.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 5527 is shown in the following table. The costs of this legislation would fall within budget functions 370 (mortgage and housing credit) and 600 (income security)

BASIS OF ESTIMATE

CBO estimates that enacting H.R. 5527 would reduce direct spending by a total of $188 million over the 2006-2011 period. Most of the estimated savings would be recorded in the year of the bill's enactment. For this estimate, CBO assumes that H.R. 5527 will be enacted by the end of fiscal year 2006.

Savings would result principally from avoiding defaults on FHA-insured mortgages that are anticipated under current law. Those estimated FHA savings would be reflected in the budget on a present value basis as "loan modifications" under the provisions of the Federal Credit Reform Act.

Subject to the availability of appropriations, CBO estimates that implementing H.R. 5527 would result in savings of $33 million over the next five years from the reduction of HAP contract rents, assuming that appropriations are reduced accordingly. CBO also estimates that expanding exception rent authority from 5 percent of the portfolio to 9 percent would cost $8 million, assuming appropriation of the necessary amounts. Thus, CBO estimates that implementing this bill would yield net discretionary savings of $25 million over the 2007-2011 period.

Background

In 1997, MAHRA was enacted to address financial problems in the Section 8 program for affordable housing assistance. At that time, over 4,000 multifamily projects with FHA-insured mortgages were receiving project-based rent subsidies under Section 8 of the United States Housing Act of 1937. The original HAP contracts attached to these projects were written for periods typically ranging from 15 to 40 years. The majority of these projects had units with rents that exceeded those for comparable unassisted units; however, the Department of Housing and Urban Development (HUD) did not have the authority to renew the contracts at above-market rents. Consequently, few of these projects would have remained financially viable when their rental income was reduced to market rates as owners would not have been able to cover their costs. With reduced rents, such projects would have been expected to default on their mortgages, generating large losses to the FHA insurance fund and possibly displacing many tenants in these projects.

ESTIMATED BUDGETARY EFFECTS OF H.R. 5527

	By Fiscal Year, in Millions of Dollars					
	2006	2007	2008	2009	2010	2011
CHANGES IN DIRECT SPENDING						
Extend Restructuring Authority Through 2011	-173	0	0	0	0	0
Estimated Budget Authority	-173	0	0	0	0	0
Estimated Outlays						
Expand Eligibility to Properties Damaged in Disasters						
Estimated Budget Authority	-11	-1	-1	-1	-1	-1
Estimated Outlays	-11	-1	-1	-1	-1	-1
SPENDING SUBJECT TO APPROPRIATION						
Spending Under Current Law for Project-based Rental Assistance						
Estimated Authorization Level [a]	5,037	5,404	5,605	5,935	6,321	6,657
Estimated Outlays	5,883	5,738	5,523	5,801	6,164	6,520
Proposed Changes						
Section 8 Rental Assistance						
Estimated Authorization Level	0	-3	-4	-8	-11	-12
Estimated Outlays	0	-2	-4	-6	-10	-12
Exception Rents						
Estimated Authorization Level	0	1	1	2	3	3
Estimated Outlays	0	*	1	2	2	3
Proposed Spending Under H.R. 5527 for Project-based Rental Assistance						
Estimated Authorization Level	5,037	5,402	5,602	5,929	6,313	6,648
Estimated Outlays	5,883	5,737	5,520	5,796	6,157	6,511

NOTES: Components may not sum to totals because of rounding.

* = Less than $500,000.

a. The amount shown for 2006 is the amount appropriated for project-based rental assistance in that year. The 2007-2011 levels are CBO baseline projections, assuming adjustments for anticipated inflation and the renewal of all units.

The mark-to-market process usually involves reducing a project's rents to market levels and then either modifying or refinancing the existing mortgage at an amount that could be supported by the new market rents (this process is often referred to as a "full" restructuring). Specifically, FHA prepays all or a portion of the owner's existing mortgage debt through a partial payment of claims (PPC) and then takes back a second mortgage, and in some cases a third mortgage, to recover some of the PPC. In some instances, though, only a property's rent is reduced to market levels; this type of restructuring (referred to as a "lite" restructuring) usually occurs when the project is physically and financially sound enough to operate at market-level rents with its existing mortgage.

Under current law, when MAHRA expires, HUD will still be required to renew HAP contracts at market levels, but the authority to restructure mortgage debt will no longer be available for projects that have yet to enter the mark-to-market program. Without that authority, many projects would not generate sufficient cash flow to support their mortgage after rents are reduced to market levels.

Direct Spending

CBO estimates that enacting H.R. 5527 will result in savings principally by avoiding defaults on FHA-insured multifamily mortgages that otherwise would occur under current law.

Avoiding FHA Multifamily Defaults through Mark-to-Market. Information provided by HUD demonstrate that at the end of fiscal year 2005, about 1,400 projects have undergone full restructuring since MAHRA was enacted in 1997. By extending the mark-to-market authority through 2011, CBO estimates that an additional 600 properties with FHA-insured mortgages would have their mortgage debt restructured.

Based on a review of financial information on nearly 1,100 projects that were restructured since the program was reauthorized in 2001, CBO estimates that the cost of restructuring mortgage debt is less expensive than the cost of default by about $500,000 per project, on average. Our analysis indicates that, on a present value basis, defaulted projects would have cost the FHA insurance fund an average of $2.2 million per project, while restructured projects have cost the FHA insurance fund an average of $1.6 million each since the program was reauthorized in 2001. The costs of defaults represent payments covering the remaining balance on the mortgage. Based on information provided by HUD, CBO does not expect any significant net recoveries on defaulted assisted properties. HUD expects to sell assisted properties that default to buyers interested in maintaining the property as affordable housing for a nominal value.

The cost of restructuring mortgage debt includes the payment covering the remaining balance on the mortgage plus amounts used for rehabilitation (an estimated 81 percent of the loan's unpaid balance or about $1.7 million per project, on average), the fees paid to the public or private organization that assists the Office of Affordable Housing Preservation with mark-to-market activities (about $55,000 per project), and the FHA subsidy cost associated with guaranteeing the new first mortgage ($32,000 per project), less the present value of expected receipts from repayments on the second mortgage ($129,000 per project). HUD expects to sell the second mortgages after holding them for about five years.

The additional restructurings that could occur under H.R. 5527 would reduce the cost to the FHA insurance fund over the remaining life of the affected loan guarantees. If the mark-to-market program ends, CBO assumes, based on data provided by HUD and discussions with industry experts, that about 90 percent of the 600 projects whose mortgages have not yet been restructured would default. The remaining 10 percent of projects are assumed to either be sustainable at market rents or would not have their rents reduced to levels that would result in a default absent the debt restructuring tools authorized by the mark-to-market program. For these projects that are not expected to default, enacting this bill would result in restructuring costs only.

Because enacting H.R. 5527 would change the expected cash flows associated with the FHA multifamily loan guarantee program, that loan restructuring is considered to be a modification of existing federal loan guarantees. Under credit reform procedures, the costs of a loan modification are estimated on a net-present-value basis in the year in which the legislation is enacted. Assuming that the bill is enacted late in fiscal year 2006, CBO estimates savings of $173 million this year. (Such estimated savings would be recorded in 2007 if the bill is enacted after September 30, 2006.)

Expand Eligibility to Properties Damaged by Disasters. Section 4 of the bill would extend restructuring authorities to projects that suffered substantial damage in a county that was declared a Major Disaster Area on or after January 1, 2005. To be eligible, properties must have sustained damage that is likely to exceed $5,000 per unit beyond what is covered by casualty and liability insurance. Based on information provided by HUD, CBO estimates that approximately 130 properties were moderately to severely damaged by storms in 2005. The mortgages on these properties have an estimated unpaid balance of about $1.4 million per project. CBO assumes that full claims will be paid on these properties as part of the restructuring process to cover the cost of repair. Because the restructurings would change the expected cash flows for these properties, such restructurings would constitute modifications of existing federal loan guarantees. CBO estimates that allowing these properties to have their debts restructured would generate savings that on a net-present-value basis would amount to $11 million this year.

In addition to the projects damaged last year, any projects damaged by future disasters would also be eligible for restructuring assistance. Based on an analysis of past disasters, CBO estimates that an average of 10 projects will be damaged each year. Assuming that restructuring the debt on these properties saves about $70,000 compared to the cost of default, CBO estimates that this provision would save an additional $500,000 to $1 million a year over the 2007-2011 period. (The authority provided in section 4 would end in 2011.)

Spending Subject to Appropriation

Section 8 Rental Assistance. CBO estimates that by extending MAHRA through 2011, the rents for properties that have their debt restructured would be reduced more than is expected under current law. Based on discussions with industry experts, CBO anticipates that the debt restructuring tools authorized by MAHRA allow HUD to move more quickly in reducing rents than would otherwise be the case, particularly in areas where comparable rents are difficult to find. Since the program was reauthorized in 2001, rents for projects that have had their debt restructured have been reduced by 21 percent, on average. Assuming that rent reduction for the 64,000 units in the 600 restructured properties would be about 10 percent less (or about 19 percent) absent the debt-restructuring tools, CBO estimates that implementing the bill would result in discretionary savings of $2 million in 2007 and $33 million over the 2007-2011 period, assuming that appropriations are reduced to reflect the lower cost of the HAP contracts.

Exception Rents. Section 3 of the bill would increase HUD's authority to set exception rents above 120 percent of the fair market rent (FMR) from 5 percent to 9 percent of all units subject to restructuring. Based on data provided by HUD, CBO estimates that such exception rents are, on average, about 14 percent higher (or $850 per year) than they would be if limited to 120 percent of the FMR. The expansion of the exception authority would allow an additional 3,200 units to establish exception rents, CBO estimates. Expanding the exception rent authority would require the appropriation of $9 million over the 2007-2011 period, which would result in estimated outlays of $8 million over that period.

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 5527 contains no intergovernmental or private-sector mandates as defined in UMRA. Reauthorization of the mark-to-market program would extend cooperative agreements between HUD and participating state and local agencies. Any costs incurred by those agencies as part of the agreements would be incurred voluntarily.

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